



Oklahoma Economic Report™

News and analysis of Oklahoma's economy

A publication of the Office of the State Treasurer • Treasurer Ken Miller, Ph.D.

The outlook for interest rates

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Interest rates normally follow the economy's business cycle, falling in a recession and then rising in an economic recovery. In the past two years, however, interest rates have not followed the normal pattern and remain exceptionally low even though the recent recession ended more than two years ago.

Indeed, short-term interest rates remain near zero and longer-term rates are the lowest in many decades. While low rates

are a boon to borrowers, they tend to hurt savers and investors who are unable to achieve decent investment returns without taking on increased risk.

This article examines the outlook for interest rates by focusing on three questions: Why are interest rates so low? When are rates likely to rise to more normal levels? What is the likely impact of the U.S. debt crisis on interest rates?

Why are interest rates so low?

To understand why interest rates have not risen in this economic expansion, it is important to understand their underlying determinants. Short-term

interest rates, those from overnight out to one to two years, are most heavily influenced by Federal Reserve monetary policy.

For the past two years, the Fed has pursued an exceptionally accommodative policy to try to strengthen a very weak expansion and lower the unemployment rate. Thus, the Fed has expanded its balance sheet and put excess funds into the banking system to try to maintain low interest rates.

In contrast, while longer-term interest rates are affected by Fed policy, they are also heavily influenced by the state of the economy and inflation. Indeed, what matters for the level of longer-term rates

SEE RATES PAGE 3

Inside

- Treasurer's Commentary: Concerning confidence
- States brace for ripple effects
- July revenue shows moderated economic growth
- Cost-cutting plans implemented
- Economic Indicators

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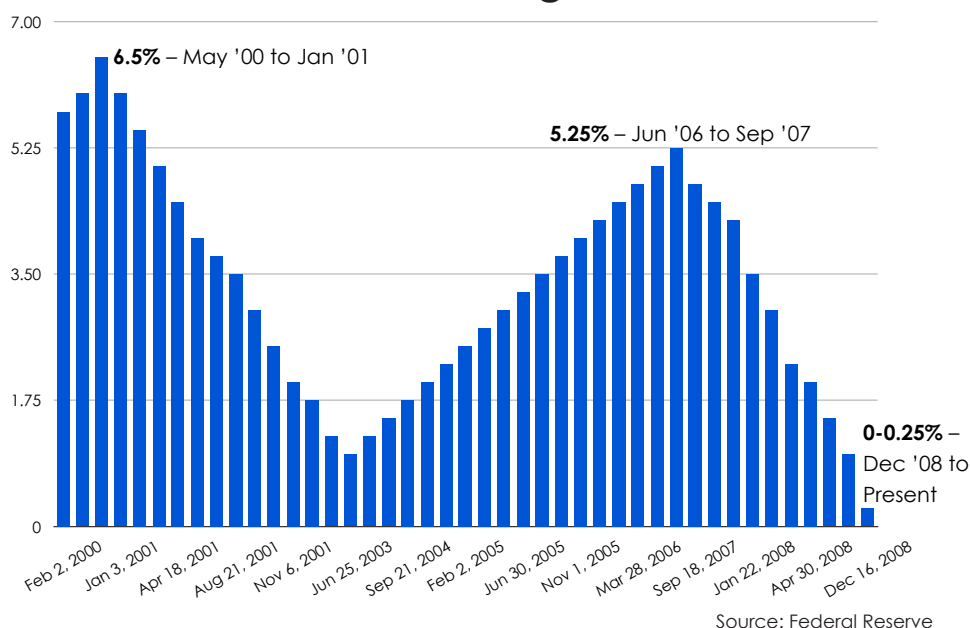
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Fed Funds Target Rate





Treasurer's Commentary By Ken Miller, Ph.D.



Concerning confidence

It is widely understood that a free market economy has many variables on which growth is dependent. Less understood is the impact of the intangible determinant called confidence – how people *feel* about their financial situation, business and the direction of the country.

Lately, there has been a great deal of attention focused on this translucent and sometimes irrational economic variable. Such discussions center on how recent events affect public confidence.

The consensus is that insufficient fiscal policies, the credit downgrade, debt problems here and abroad, geopolitical events and volatility in the stock market have lessened consumer, producer and investor confidence and have contributed to anemic GDP and job growth.

An economist from Moody's rating agency blamed the current economic malaise on a "crisis of confidence." The fear is that the negativity will create a self-fulfilling prophecy resulting in a vicious downward cycle and another recession.

In spite of the recent negative financial news coming out of Washington and Wall Street, there

are many reasons to remain bullish on the direction of Oklahoma's economy. Although the external threats to our economy are real, our state continues to outperform much of the nation as demonstrated, in part, by a nearly eight percent increase in gross receipts from income, sales and energy taxes for the past 12 months.

“ . . . there are many reasons to remain bullish on the direction of Oklahoma's economy.”

The fundamentals underlying Oklahoma's economy have gained strength. Our leading sectors continue to expand and corporate profits are good, keeping our unemployment rate one of the lowest in the country. Productivity growth in Oklahoma was twice the U.S. rate for the first half of the year, and our banks and real estate prices remain healthy.

Of course, economic concerns remain for Oklahoma. Chief among them are

the Washington-inflicted wounds to the recovery and their affect on our state prospects. Job growth is not what it needs to be to provide full employment for our citizens and investment returns are hampered by extraordinarily low yields and stock market volatility.

In spite of the downgrade by one rating agency, default was avoided and U.S. government debt remains among the safest in the world. Taxpayer funds are safe and liquid.

The current drop in yields has reduced fixed-investment earnings in the short term, but like investments with equity positions, will recover and grow with time.

Though difficult, one can find a silver lining or two in the nation's current financial problems. The recent turmoil may have sent a wake-up call to federal policymakers forcing them to finally address the country's long-term fiscal health. Low rates provide the opportunity to finance

SEE CONFIDENCE PAGE 3



Confidence

FROM PAGE 2

infrastructure improvement projects at less cost to the taxpayers.

Even a student of the dismal science can remain optimistic. While concerns over a double-dip recession are more understandable today than six months ago, predictions of another downturn are extremely premature.

Confidence can be restored and the feared vicious cycle can become a virtuous one if our nation's leaders take credible action to put our financial house in order.

Rates

FROM PAGE 1

are investor expectations about future economic growth and inflation as well as future Fed policy.

Longer-term rates are currently low for three reasons: the current economic recovery has been weaker than normal, especially in terms of job creation, and is expected to remain weak, longer-term inflation expectations remain low despite increases in food and energy prices, and the Fed is seen as in no hurry to normalize monetary policy.

When will rates rise to more normal levels?

In my view, interest rates will begin to rise to more normal levels when the factors keeping them low begin to dissipate. In terms of monetary policy, the Fed is unlikely to begin to tighten policy until the economic recovery strengthens considerably, with sustained increases in employment.

Even then, the Fed may have difficulty pushing short-term rates up because it will take time to reduce the excess supply of reserves in the banking system and the size of its balance sheet.

Because Fed policy is likely to be conditioned on the state of the economy, it is difficult to attach a specific time frame to its decisions, but recent statements by the Fed suggest that short-term rates are likely to remain low at least through mid-2013.

In contrast, longer-term rates could rise more quickly, even before short-term rates, if investors anticipate stronger economic growth or a sustained increase in inflation pressures and believe that this could trigger a faster path of Fed policy tightening.

What is the likely impact of the U.S. debt crisis on interest rates?

Another factor that could influence interest rates is the U.S. debt crisis. Recently, concerns over possible government debt default in Greece and some other European countries have led to a sharp rise in interest rates in those countries even though their economies are weak and inflation remains low.

With investors recognizing that the U.S. also has a serious long-term fiscal problem, there has been increased concern that a downgrade in the U.S. government's credit rating could lead to a similar increase in U.S. interest rates, further slowing the economy.

In my view, it is a mistake to lump the U.S. into the category of countries that are unable to pay their bills. The recent budget debate is more about priorities than solvency. That said, it is imperative political leaders in Washington make the hard decisions needed to restore long-

term fiscal balance, or solvency could be an issue in the future.

In this context, I do not think the recent decision by Standard and Poor's to lower the U.S. government's credit rating will have a major effect on interest rates for several reasons.

“ . . . it is a mistake to lump the U.S. into the category of countries that are unable to pay their bills.”

First, the decline in the credit rating is small and mostly symbolic, so that investors are unlikely to perceive a material rise in the credit risk of the U.S. government. Second, even with the credit downgrade, international investors are likely to see U.S. government securities as relatively more attractive than other countries' securities.

This will maintain the demand for U.S. securities and prevent interest rates from rising dramatically.

Finally, if policymakers in Washington are able to develop a credible long-term plan to reduce deficits and the outstanding debt, this will lower the expected future supply of Treasury securities, which will tend to reduce future interest rates and offset the effects of a lower credit rating.

Dr. Sellon retired in 2009 as senior vice president and director of research for the Kansas City Federal Reserve. He joined the Fed in 1979.



States brace for ripple effects

The unprecedented credit downgrade of the U.S. has states worried about ripple effects. As they continue to struggle to gain economic traction, states now face uncertainty about the inflow of federal funds, investment returns and borrowing costs, and signals from rating agencies that many states are likely to see a rating demotion if balance sheets don't improve.

Historically, a state's credit worthiness is determined by evaluating:

- institutional framework, including fiscal policy structures;
- financial management of the state budget;
- economic variables, such as demographics and economic development policies; and
- debt burden, including pension liabilities and public employee benefits.

Also considered is a state's willingness and ability to use debt as a tool to finance infrastructure projects. But a new and less measurable consideration has recently emerged: the likelihood of government leaders to work together to resolve financial challenges.

S&P backed its action against the U.S. with criticism of political leadership too dysfunctional and divided to provide the stability and predictability needed in a weak economy.

Likewise, the rating agencies are taking note of political environments and each state's ability to implement credible solutions. Just this week, Fitch announced a downgrade of New Jersey's bond rating; the third rating agency to do so within the last six months. Fitch, S&P and Moody's each cited as a concern New Jersey's high debt burden and significant long-term pension and

employee benefits obligations. In its April downgrade, Moody's noted a "structurally imbalanced" budget paired with rising pressures on the state's budget. Fitch's analysis was skeptical of reform pledges, noting the state's history of under funding pension and benefit programs.

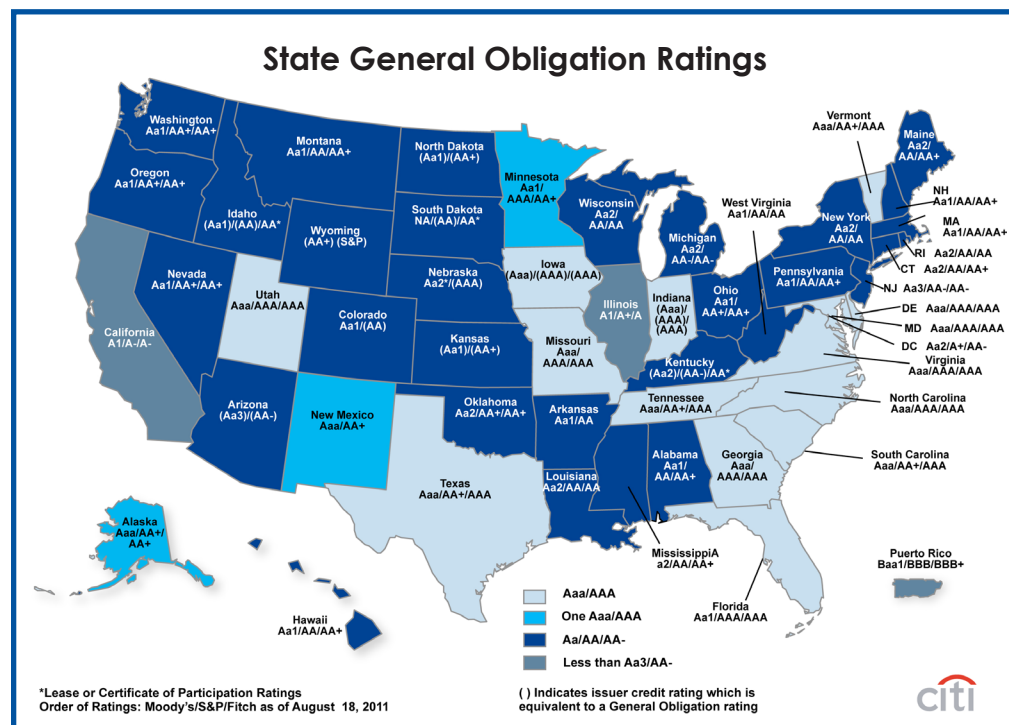
New Jersey hasn't yet felt the full impact of being rebuked by all three rating agencies, but it's not likely to help a state whose recovery is already limping behind the rest of the nation. California and Illinois are in even worse fiscal shape according to Moody's, which ranks the two states as the least credit-worthy in the nation.

In the past decade, states have experienced more credit upgrades than downgrades. And rating agencies are recognizing those entities that are getting it right on matters of fiscal import. In its upgrade of six states this year, S&P praised sound management practices that warranted the enhanced rating.

There seems to be a growing consensus that the recent U.S. credit downgrade will have little direct impact on the states. Many states recently downgraded do not anticipate immediate repercussions from those actions; instead, they are more concerned with their dependence on federal funding.

Some analysts note the rating changes only served to confirm what was already known about a state's ability to repay its debt. Further, the stock market volatility has fueled a flight from stocks to bonds, keeping borrowing costs low.

However, the increased attention to fiscal policies and political willingness to tackle systemic problems will likely determine tomorrow's leaders and laggards.





July Gross Receipts & General Revenue Fund comparison

A comparison of the Treasurer's August 2 Revenue Report and State Finance's August 8 General Revenue (GR) Fund report demonstrates key differences.

July gross receipts totaled \$845.4 million, while GR received \$385 million or 45.5 percent of the total.

The difference is due to variances in the transfer of funds for rebates, remittances and dedicated funding.

In July, the GR Fund received:

- 61.2 percent of personal income tax
- 26.3 percent of corporate income tax
- 45.5 percent of sales tax receipts
- 33.7 percent of gross production taxes on oil and natural gas
- 26.2 percent of motor vehicle tax collections
- 39.2 percent of other revenue sources

Collections from tribal gaming generated \$9.6 million during the month.

Insurance premium taxes generated \$984,000 in July.

Treasurer says energy industry continues to lead revenues

July revenue shows moderated economic growth

July revenues show moderate economic growth as collections continue to beat the prior year, although collections have pulled back from the double-digit numbers seen last month, Treasurer Ken Miller announced as he released the state's monthly gross revenue report.

"July collections were up by 6.8 percent from July of last year and 14.4 percent above July 2009," Miller said.

"With year-over-year growth last month exceptionally strong at 15.5 percent, it is not surprising to see growth moderate some this month."

Miller said collections over the past 12 months totaled \$10.259 billion; the highest level since July 2009, when 12-month collections totaled \$10.402 billion.

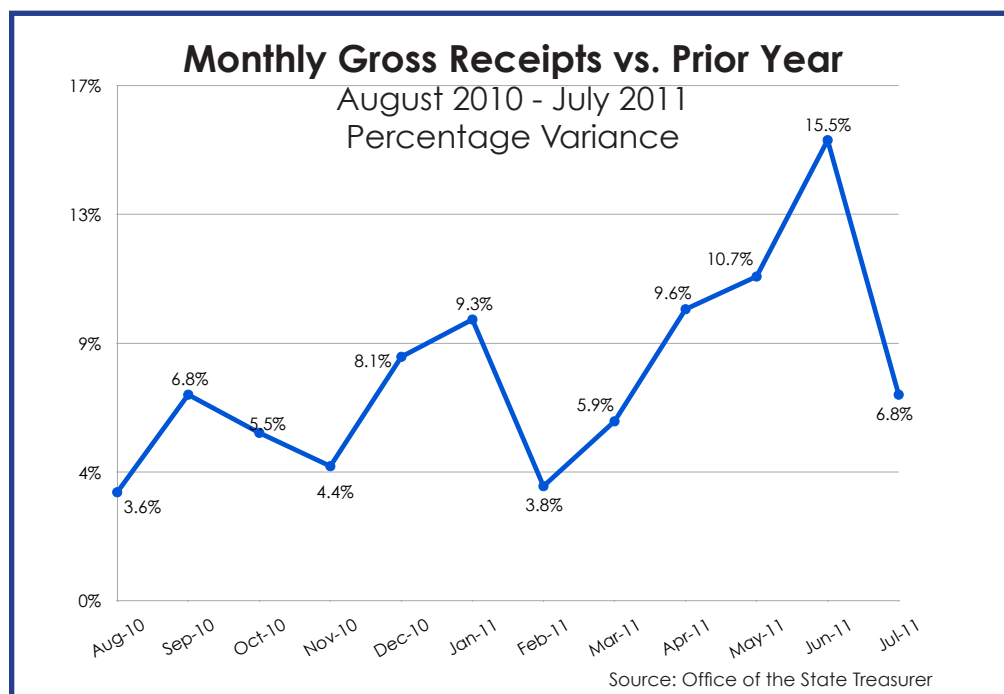
Debt ceiling and weak national growth

Miller said Oklahoma's economy has most likely felt the dampening effects of forces outside its borders.

"It is likely the showdown over the federal debt ceiling negatively impacted Oklahoma by providing uncertainty to markets and eroding producer, consumer and investor confidence in the recovery," he said.

"Although the compromise bill is a small step in the right direction and stems the immediate crisis, it does little to address the systemic federal spending problem and nothing to actually reduce debt that is 100 percent of our GDP.

SEE REVENUE PAGE 6





Revenue

FROM PAGE 5

With passage of the bill, the U.S. will still borrow money to finance current expenditures and will continue to add to our national debt.

“I hardly think Washington should congratulate itself for averting an economic meltdown of its own making,” Miller continued.

“Predictions that states will bear the burden of federal cuts seem to be overstated. The spending reductions are relatively small with the more significant cuts years away and entitlement spending, like Medicaid, completely exempt from the cuts.

“To the extent that future costs are shifted to the states, that will provide further opportunity to force better prioritization and to re-examine the proper role of government,” he concluded.

Because macro conditions eventually affect Oklahoma, recent national economic data is also of concern, Miller said.

“Recent data from the Bureau of Economic Analysis show the U.S. economy expanded at an annual rate of just 1.3 percent in the second quarter, not near as strong as expected,” he said. “Of even more concern is that revisions to first quarter GDP show growth at only 0.4 percent.”

“It is likely the showdown over the federal debt ceiling negatively impacted Oklahoma.”

Projections of national economic growth have been scaled back recently due to flat job growth numbers, geopolitical factors and data from the Institute for Supply Management that show worsening manufacturing conditions.

Cost-cutting plans implemented

Last session’s passage of Governor Fallin’s initiatives to consolidate and modernize state operations has great potential to reduce costs.

Consistent with those efforts, two projects in the strategic plan of the treasurer’s office are currently being implemented to bring long-term savings and efficiency to the state.

Out with the obsolete

Using money saved through various cost-cutting measures, work is underway to replace an antiquated software program used to keep track of billions of state dollars.

The state’s General Ledger program was written in COBOL, one of the oldest computer languages developed in 1959. Technical support for the

program became increasingly difficult to maintain as modern day programmers do not receive training in this obsolete language. Even so, replacement had to be delayed for several years until sufficient savings accumulated to pay for a modern system.

The new program will allow for many years of use with greatly improved security, efficiency and reliability.

More for less

To further reduce costs, the Treasurer’s Office is shrinking its footprint through the elimination of leased office space made possible by the reduction in force of 27 positions in the past four years.

The banking operations workspace consolidation, a cost-savings initiative begun by Treasurer Meacham and being completed by Treasurer Miller, is an

ongoing effort to gain efficiencies and reduce costs.

The consolidation will yield savings through a reduction in leased commercial space and will address long-standing security concerns with the vault and teller windows.

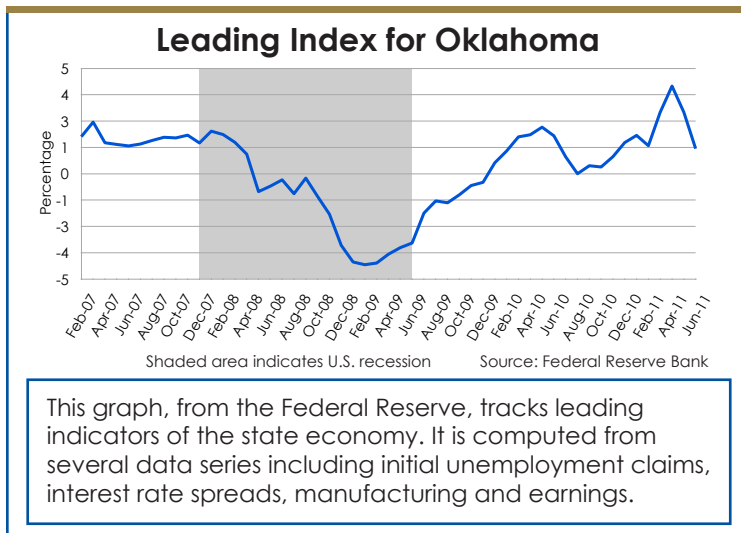
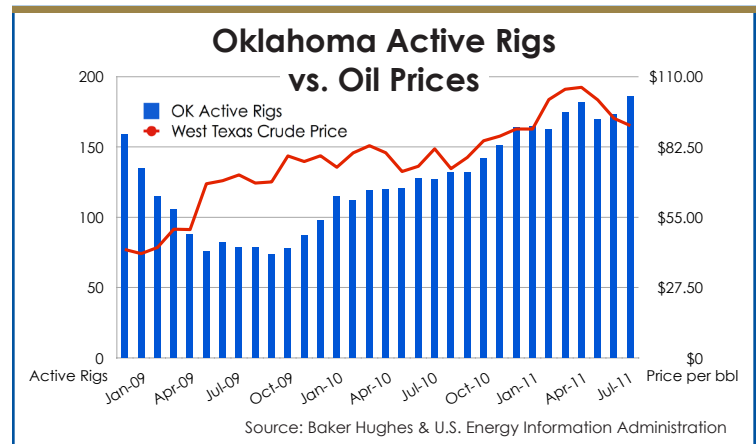
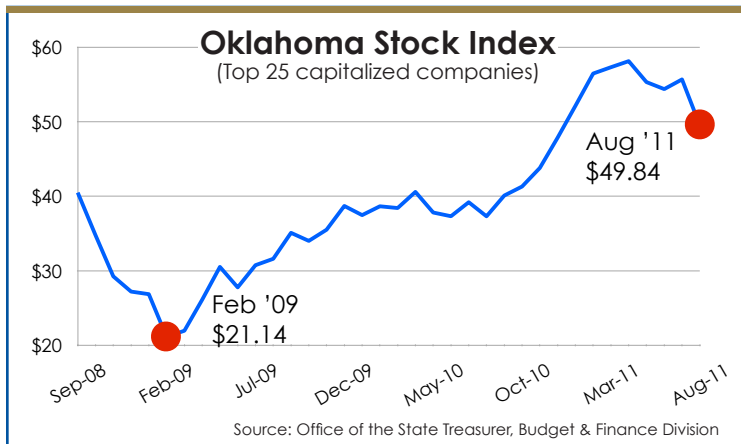
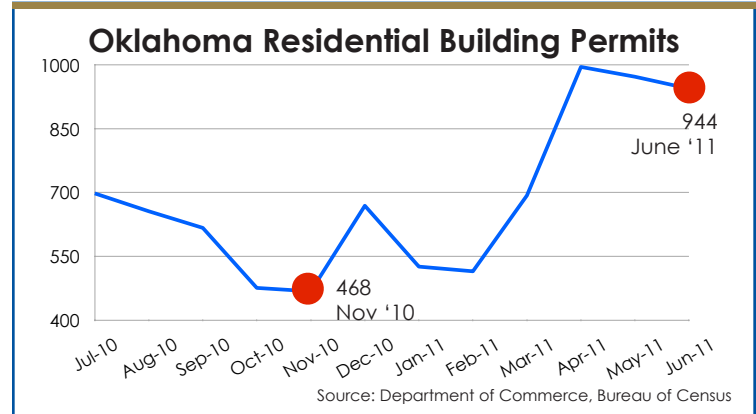
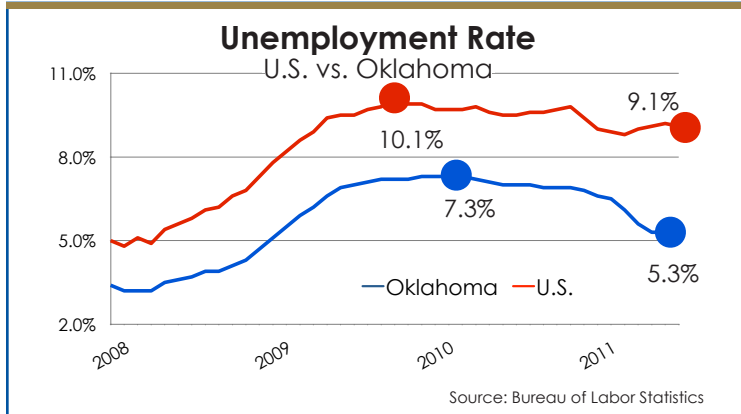
The workspace changes, the first in more than 20 years, will relocate to the banking operations area of the Capitol personnel that have been moved out of rental space.

The more efficient floor plan will make room for employees that are currently utilizing temporary work spaces, including two who are sharing an office with the treasurer.

The project will result in a 32 percent increase in the number of workstations within the existing office area and contains no changes to Treasurer Miller’s office.



Economic Indicators



Interest Rate Forecast

68 Economists

| | 3Q 2011 | 4Q 2011 | 1Q 2012 | 2Q 2012 | 3Q 2012 | 4Q 2012 |
|----------------------------|-------------|-------------|-------------|---------|---------|---------|
| Fed Funds Target | 0.25% | 0.25% | 0.25% | 0.50% | 0.75% | 1.00% |
| 3-M LIBOR | 0.30% | 0.37% | 0.43% | 0.68% | 0.99% | 1.35% |
| Treasury Notes | | | | | | |
| 2-Year | 0.60% | 0.77% | 1.00% | 1.28% | 1.60% | 2.00% |
| 10-Year | 3.25% | 3.50% | 3.70% | 3.80% | 4.10% | 4.20% |
| Treasury Bonds | | | | | | |
| 30-Year | 4.40% | 4.50% | 4.63% | 4.80% | 4.98% | 5.17% |
| Economic Indicators | 2011 | 2012 | 2013 | | | |
| Real GDP | 2.50% | 3.00% | 3.20% | | | |
| Unemployment | 8.90% | 8.30% | 7.60% | | | |

Source: Median forecasts for key economic indicators as surveyed by Bloomberg August 10, 2011.